Union Calendar No. 425

94th Congress, 2d Session - - - - - - - - House Report No. 94–840

SELECTED SMALL BUSINESS ADMINISTRATION PROGRAMS AND ACTIVITIES

A REPORT

OF THE

SUBCOMMITTEE ON SBA OVERSIGHT AND MINORITY ENTERPRISE

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

NINETY-FOURTH CONGRESS
SECOND SESSION

February 24, 1976.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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LETTERS OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C., February 24, 1976.

Hon. CARL ALBERT,
The Speaker, U.S. House of Representatives, Washington, D.C.

DEAR MR. SPEAKER: Transmitted herewith is a report of the Committee on Small Business entitled "Selected Small Business Administration Programs and Activities."

This report is submitted with the approval of the full Committee.

With kindest regards and best wishes, I am

Very sincerely yours,

JOE L. EVINS, *Chairman.*

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON SBA OVERSIGHT
AND MINORITY ENTERPRISE,
Washington, D.C., February 24, 1976.

Hon. JOE L. EVINS,
Chairman, Committee on Small Business, U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Transmitted herewith is a report of the Subcommittee on SBA Oversight and Minority Enterprise entitled "Selected Small Business Administration Programs and Activities."

This report is submitted with the approval of the subcommittee.

With kindest regards, I am

Sincerely,

JOSEPH P. ADDABBO,
Chairman, Subcommittee on SBA Oversight and Minority Enterprise.

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Union Calendar No. 425

94th Congress, 2d Session } HOUSE OF REPRESENTATIVES { Report No. 94-840

SELECTED SMALL BUSINESS ADMINISTRATION PROGRAMS AND ACTIVITIES

February 24, 1976.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. Evins of Tennessee, from the Committee on Small Business, submitted the following

REPORT

SELECTED SMALL BUSINESS ADMINISTRATION PROGRAMS AND ACTIVITIES

Introduction

The Subcommittee on Small Business Administration Oversight and Minority Enterprise, chaired by Representative Joseph P. Addabbo (Democrat of New York), conducted hearings on November 20, 1975, to investigate certain selected programs and activities of the Small Business Administration.

In addition to Chairman Addabbo, the subcommittee is comprised of the following members: Representative James M. Hanley (Democrat of New York); Representative Fernand J. St Germain (Democrat of Rhode Island); Representative Henry B. Gonzalez (Democrat of Texas); Representative Frederick W. Richmond (Democrat of New York); Representative Alvin Baldus (Democrat of Wisconsin); Representative John Breckinridge (Democrat of Kentucky); Representative Thomas J. Downey (Democrat of New York); Representative Tim Lee Carter (Republican of Kentucky); Representative William F. Goodling (Republican of Pennsylvania); and Representative Hamilton Fish, Jr. (Republican of New York).

Representative Joe L. Evins, Democrat of Tennessee, Chairman of the full Committee, and Representative Silvio O. Conte, Republican of Massachusetts, Ranking Minority Member, are *ex officio* Members of the Subcommittee.

Subjects under investigation at the hearing included the Small Business Administration Surety Bond Guarantee Program and purported First Amendment restrictions on SBA's loan eligibility criteria. Circumstances strongly dictate that these two topics be afforded a priority of concern by this Committee. Consequently, this Report is limited to these subjects and the grave issues they raise for the small business community.

H. Rept. 94-840——2

Part 1.—The SBA Surety Bond Guarantee Program

CHAPTER I: SUMMARY OF TESTIMONY

The Subcommittee is in receipt of numerous communications from small business concerns and sureties stating that the Small Business Administration Surety Bond Guarantee Program (SBG) is in a perilous financial condition and, moreover, is not realizing its intended purpose. In fact, the Subcommittee has been informed by the SBA that unless certain actions are expeditiously undertaken, the SBG Program will be in a paralyzing cash position by the summer of 1976.

On this subject, the Subcommittee actively solicited and received testimony from: the Central Contractors Association, a business association funded by the Office of Minority Business Enterprise of the Department of Commerce, which provides management and technical assistance to 169 minority contractors. Mr. Joseph Debro, representing JDA Consulting Group, Inc., a firm specializing in developing and implementing affirmative action plans for industry and government; the Surety Association of America, representing 425 insurance companies which write surety bonds; Richard D. Turner, Esq., representing several specialty surety companies which have written 38% of the total contract bonds obtained through this program; the Associated General Contractors of America, representing 8,200 general contracting firms and 17,500 subcontractors, suppliers and other firms closely related to general contractors; the American Insurance Association, which has a membership of over 130 companies responsible for approximately two-thirds of the premium volume on contract surety bonds written throughout the United States; Imperial Agents, Ltd., a licensed insurance agency in the State of Illinois specializing in the SBG Program; and the SBA, represented by its Acting Administrator, Louis F. Laun.

The Subcommittee believes the testimony received adequately represents the spectrum of interests to be considered and summarizes that testimony as follows:

As a basic proposition, the Subcommittee understands the function of a surety to center upon its role as a guarantor of some contractual performance to take place in the future. Pursuant to the Small Business Investment Act of 1958, as amended, the SBA is authorized, in certain qualifying circumstances, to pay a surety:

> A sum not to exceed 90 per centum of the loss incurred by the surety in fulfilling the terms of his contract as the result of the breach by the principal of the terms of a bid bond, performance bond, or payment bond.[1]

[1] For the full text of the statute establishing the SBA Surety Bond Guarantee Program see Appendix A.

The witnesses differed as to the type of contractor they perceived the program was primarily designed to benefit. According to the Surety Association of America, the program was designed and should be implemented to focus mainly on the peculiar problems of newly emerging minority-owned business concerns. The Central Contractors Association and Mr. Debro of JDA Consultants denied that such was the intent of the program, but readily conceded that the SBA program is extremely beneficial to minority business. In fact, the Subcommittee was informed by these two witnesses that they knew of no minority contractors in the Seattle, Washington area who were receiving bonds without this SBA assistance. Specialty sureties, represented by Richard Turner, expressed what appeared to be a more fundamental approach and stated that the program was designed to enable contractors to obtain bonds, otherwise unavailable, whether they were minority-owned or newly emerging small businesses.

The Subcommittee inquired as to the need for bonding in the construction field and was informed that most "profit work" (i.e., non-governmental work) does not usually require the posting of a surety bond as a guarantee for performance. Rather it is the government financed projects which require such assurances.

On the Federal level, the Miller Act (40 U.S.C. § 270a *et seq*), enacted in 1935, requires that a contractor must obtain a performance bond and a payment bond "Before any contract, exceeding $2,000 in amount, for the construction, alteration, or repair of any public building or public work of the United States is awarded to any person . . ."[2] The Subcommittee was informed that $2,000 in 1935 dollars is equivalent to $40,000 in today's economy, and that, consequently, the Act should be amended to reflect present economic reality.

The statement submitted by Imperial Agents Ltd. advised the Subcommittee that over 65% of all construction being proposed or currently in progress is owned by federal, state or local government agencies and that "Almost every one of these contracts requires bonding." The American Insurance Association stated unequivocally that the surety industry could not accommodate the governmental demand for payment and performance bonding without the SBG Program.

Statistics indicate that the SBG Program has grown at a phenomenal rate since its effective date in 1971.

EXHIBIT 1

NUMBER AND DOLLAR VALUE OF SURETY BOND GUARANTEE CONTRACTS

	Number of contracts awarded	Dollar value of contracts
Fiscal year—		
1971	7	312,252
1972	1,339	94,434,157
1973	5,597	351,189,011
1974	9,182	633,229,829
1975	11,595	760,152,366
1976 (4 mo)	4,966	318,289,684

[2] Relevant procurement rules and regulations also require the attainment of bid bonds in such situations.

At this high level of activity, the SBA has guaranteed, within a period of less than five years, surety contracts valued in excess of $2 billion.

EXHIBIT 2

SURETY BOND GUARANTEE

[January 1971 to December 1975]

Regions	Guarantees approved by SBA	Number of guarantees maturing to contract awards	Value of contracts	Average contract value
I	1,110	858	$66,377,848	$77,363
II	2,012	1,389	113,374,478	81,623
III	3,739	2,763	169,854,286	61,475
IV	11,703	6,029	488,160,532	80,969
V	6,546	4,983	292,562,566	58,712
VI	9,240	5,847	417,122,879	71,340
VII	2,218	1,277	71,041,689	55,632
VIII	1,914	1,107	78,357,393	70,784
IX	16,755	8,340	449,872,327	53,942
X	3,918	2,186	142,234,888	65,066
Total	59,155	34,779	2,288,958,886	65,814

Section 411(c) of the Small Business Investment Act mandates that the SBA "administer this program on a prudent and economically justifiable basis" and further requires the Administration to set certain "reasonable and necessary" fees and charges as may be required to accomplish this purpose.

Administrative regulations have implemented this mandate and the SBA now assumes 90 percent of any potential loss which may occur as the result of a breach of the surety contract by the principal in return for 10 percent of the premium collected by the surety from its client. The SBA also levies a premium charge on the applicant contractor at the rate of 0.2 per centum of the contract price upon the contractor's obtaining the contract. This charge pertains only to payment and performance bonds. There is no processing charge for bid bonds, rejected applications or approved applications where contracts have not been awarded. SBA is also entitled to 90 percent of any recovery made by a surety on an SBG defaulted contract.

The Subcommittee was informed by both the SBA and the Surety Association of America that the rate structure used by sureties must be filed with and approved by the State Insurance Commission of each state in which the sureties wish to do business.

For the purpose of formulating premium fee structures, the surety industry can be divided into two separate classes. The "manual rate" sureties use fees which are suggested by a national compilation of surety fees prepared by the Surety Association of America. "Non-manual" rate sureties are not stringently guided by such proposed rates but instead utilized other economic criteria.

Sureties which participate in the SBG program must use SBA formulated rate schedules for their SBG clientele. This schedule, which sets a ceiling rate, allows participating sureties to charge up to

$15/$1,000 of the first $50,000 in contract value, and no more than $10/$1,000 on any contract amount in excess of the first $50,000. The SBA advised the Subcommittee that these rates are "stringently" enforced.

In response to questions submitted by Chairman Addabbo, the SBA explained the relationship between its rate structure and that charged non-SBG contractors:

> The manual rate sureties do not charge an SBG client contractor a higher premium rate than their non-SBG client pays. The nonmanual rate sureties probably charge an SBG client contractor *less* than these sureties normally charge their non-SBG clients because the SBG rate structure ceiling is lower than these sureties' approved rates are in the various states. We know of many small and minority contractors who were paying five and six percent premium rates to obtain surety bonds before the advent and their utilization of the SBG program.

The Central Contractors Association did verify the fact that some of its client firms were being charged as high as five percent for performance bonds without the SBA guarantee. In the SBG Program, however, SBA does monitor and investigate complaints that participating sureties are charging more than the allowable rate to its SBG client contractors. In one case, related to the Subcommittee by the SBA, it was learned that one surety representative was overcharging the client contractor in violation of SBA's rate schedule, but not in violation of state law. SBA was able to obtain refunds for the contractors in this case.

Previously, the SBG Program and the Lease Guarantee Program were funded by one revolving fund authorized and appropriated $10 million to be shared among the programs (Public Law 91–609, Sec. 911(a)(3)). However, pursuant to Sec. 6 of Public Law 93–386, a new Section 412 was added to the Small Business Investment Act which created a separate revolving fund for the SBG Program. This fund was created without fiscal year limitation and there was authorized to be appropriated to the fund, from time to time, such amounts not to exceed $35 million.

SBA authorizes cash disbursements from the fund to pay for losses and administrative charges. In addition, the agency, on the basis of its past experiences, does have an expectation of how much money it will eventually have to pay out given a certain dollar amount of contracts guaranteed by SBA. Therefore, SBA's "incurred" loss ratio is a function both of cash disbursement and those losses expected to be sustained in the future. As of December 30, 1975, SBA's incurred loss is represented in the following Exhibit.

EXHIBIT 3

INCURRED LOSS OF SURETY BOND GUARANTEE PROGRAM, BY REGION, JANUARY 1971 TO DEC. 30, 1975

Region	Incurred loss (paid plus reserve)	Incurred loss rates (percent)
I	1, 392, 512	2.29
II	3, 127, 663	3.04
III	3, 040, 776	2.02
IV	7, 655, 470	1.86
V	6, 840, 215	2.88
VI	7, 377, 994	2.21
VII	926, 529	1.48
VIII	1, 298, 228	1.81
IX	14, 508, 281	3.47
X	1, 599, 634	1.30
Total	47, 767, 302	2.42

The significance of Exhibit 3 must be analyzed in terms of whether the fund is to be evaluated on a cash or an obligational basis which would take into account expected future losses.

On a cash basis, the program, as of December 30, 1975, reflects the following picture:

Fees received and recoveries received	$7, 825, 044
Expenses, claims paid and interest paid	32, 642, 539
Net difference	24, 817, 495

Subtracting the net difference from the $35 million authorized for appropriations, leaves approximately $10 million still available for obligation. Inasmuch as the pay outs authorized for the last ten months (February through November, 1975), average $1.3 million per month, the $10 million should take the program through July 1976.

If, however, the program is evaluated on an obligational basis to cover all losses, both paid and those accrued but not yet paid, we perceive a totally different picture. We must introduce into the above scenario the outstanding claim reserve. This claim reserve reflects losses already paid and reserve for losses incurred but not yet paid. This outstanding claim reserve represents incurred losses of $47,767,302 less the actual SBA pay out of $28,983,112 for a net outstanding claim reserve to December 30, 1975, of $18,784,109. (This includes reserve of $6 million to cover losses incurred by the liquidation of Summit Insurance Company, which was one of the largest participants in the SBG Program.)

If the program is continued at the current projected rate, the $10 million currently available on a cash basis would be fully committed in fiscal year 1976. On a cash basis the program should be covered for all of fiscal year 1976. On an obligational basis covering all accrued losses, however, the program would end fiscal year 1976 with an outstanding claim reserve for losses incurred, but not yet paid, of approximately $18,750,000.

Looking ahead to fiscal year 1977, if the Surety Bond Program is put on an obligational basis to cover all accrued losses, the following would be necessary in terms of authorization and appropriation:

1. Provide for the approximately $18.75 million of outstanding claim reserves accrued through the end of fiscal year 1976.

2. Provide for the interim period July 1, 1976 through September 30, 1976.

3. Provide for the program level approved for fiscal year 1977. If the program level for fiscal year 1977 is the same as fiscal year 1976, approximately $750 million in Surety Bond contracts, then applying the 2.42 percent loss rate (which is the present historic loss rate percentage), Congress would have to provide for another $18.1 million for fiscal year 1977.

Because of the unavailability of precise data on the 102 sureties which have thus far participated in the SBG Program, the Subcommittee must necessarily engage in some degree of speculation when attempting to compute the financial benefit to the surety industry as a result of this program. For fiscal year 1971 through fiscal year 1975, the following facts have been established.

Total surety bond fees (premiums)		$18, 651, 720
Less SBA's 10 percent		1, 865, 172
		16, 786, 548
Less claims paid by sureties	2, 312, 326	
Plus claims recovered by sureties	87, 384	
		2, 224, 942
Subtotal		14, 561, 606

From this Subtotal of $14,561,606 must be deducted both agent and/or brokers fees and administrative expenses. SBA estimates that sureties pay to their agents and/or brokers commissions equal to approximately 30 percent [3] of the premiums. With this benchmark in mind, the SBA computes that commissions paid through fiscal year 1975 on SBG contracts approximate $5,595,516. Of the remaining $8,966,090 ($14,561,606 minus $5,595,516), the sureties' administrative expenses must be deducted.

The evidence received did not provide the Subcommittee with a sufficient amount of reliable data whereby it may compute the administrative expenses directly attributable by sureties to their participation in the SBG Program. Excluding commissions, administrative expenses include, among other things, underwriting expenses, operating costs, taxes, licenses and fees. As is evident, some expenses are fixed and others variable. An Econometric Report prepared by the INA Reinsurance Company and forwarded to the Subcommittee by the SBA, states that during 1974, total administrative expenses (*including commissions*) accounted for 55.20 percent of the premium dollar. At first impression, it would seem that subtracting the 30 percent commission fee (approximated by SBA) from 55.20 percent would

[3] The Subcommittee realizes that the 30 percent figure is only an approximation. Commissions may, and do vary with, for instance, the size of the surety, or whether the surety wishes to provide higher compensation to its agents and/or brokers to write a particular type of business, or other economic factors.

yield the percent of the premium dollar used by sureties to meet other administrative expenses. However, upon a more careful analysis, this proposition is not tenable. This is so because, among other factors, it cannot be presumed that administrative expenses are the same for SBG business as for non-SBG business. SBG client contractors are, by definition, "unbondable" in the surety industry without an SBA guarantee. By industry standards, most are presumed to be marginal. Therefore, at least in its initial contact with a surety company, the requisite underwriting expenses, SBA paperwork and other specialized treatment would seem to indicate a higher administrative expense for SBG clients than for the traditional non-SBG clients. In addition, an across the board estimate of 55.40 percent presupposes that administrative expenses are the same for large sureties and for the smaller "specialty" sureties which write the bulk of the SBG business.

It is impossible for the Subcommittee to determine the administrative expenses sustained by participating sureties without conducting a detailed audit of each participating surety, or a representative sample. Hence, the Subcommittee cannot compute the amount of any financial benefit accruing to the surety industry as a result of this program. However, the credulity of the Subcommittee is severely strained by the contention that a highly competitive segment of the economy would participate in a Government guarantee program to the extent here evidenced, without the immediate realization or at least expectation of profit.

The Subcommittee did receive substantial evidence which was proffered as an explanation for the heavy losses sustained by SBA in this program.

The Surety Association of America and the American Insurance Association attributed the excessive losses, in substantial part, to the fact that SBA is presently authorized to guarantee surety contracts up to $1 million (see section 411(a)) and has, in fact, guaranteed many surety contracts in the $500,000 to $1 million range. Previous statutory provisions limited the dollar amount of a contract which could be guaranteed up to $350,000, which was subsequently amended to $500,000 (Public Law 91–609), and then $1 million (Public Law 93–386) respectively. The Surety Association of America testified that the program does work well with emerging contractors on contracts up to the $350,000 range, but increasing the dollar value of such contracts to include those in the $500,000 to $1 million range is responsible for the more serious problems encountered by the SBA with the program. The Surety Association of America told the Subcommittee that the focus of the program had shifted from assisting the emerging minority contractor to SBA's futile attempt "to be all things to all contractors." The Subcommittee was informed that the increased ceiling amount of $1 million was "ill-advised and should be reversed." The Surety Association of America suggested that an appropriate contract ceiling would be $350,000; the American Insurance Association urged $500,000 as the maximum allowable contract value.[4]

[4] There has been some congressional effort to increase the ceiling amount above the $1 million level. See for example, H.R. 6339 and H.R. 9209 (94th Cong.) increasing the contract amount to $5 million on contracts let by an agency of the United States.

As of November 19, 1975, SBA had approved 25 contracts in excess of $500,000 which have matured to award. The 25 contracts have a total value of $16,339,559, or an average amount of $653,582 each. As of November 19, 1975, the SBA has not received a default notice on any of these contracts.

The SBA does not have enough experience to determine whether the increase in contract limitation from $500,000 to $1 million was "ill-advised," although it believes the need for this larger amount has not been evidenced to date.

Guaranteed contracts in the $0–299,999 range comprise 88.6 percent of the cases in claim status and 74.3 percent of the aggregate dollars posted as incurred losses. While the average size of a contract guaranteed pursuant to the SBG Program is about $66,000 the average size of a contract in claim status is $123,348 or almost twice as large. The SBA expects to lose 22.3 percent of the face value of any SBG contract that goes into claim status, and therefore, the larger the job, the greater is the possible loss exposure dollar wise. However, as a percentage of the contract value, the loss rate is actually less on the larger jobs than is found among the smaller jobs.

The Associated General Contractors of America took strong exception to SBA increasing its SBG size standards for general contractors from a yearly volume of $750,000 to $2 million based on a three year average:

> The increase in the limit would permit more small firms, which lack the necessary expertise to secure bonding on the open market, to go into direct competition with self-sustaining contracting firms of similar size. We feel that the SBA guarantee is a Federal invitation to businesses to expose themselves to a high degree of risk by entering into contracts on projects that are far too complex for them to handle.

Most of the witnesses agreed that another reason for the amount of losses sustained by SBA is the severe depression which has taken place in the construction industry during the past few years.

According to the Econometric Report prepared by INA Reinsurance:

> 1974 was the first year since 1960 in which *total* construction declined. Public construction went up, but private construction fell 14 percent in 1974. This was the sharpest decrease in the postwar era. Residential construction started declining in 1973 (4 percent), then fell 27 percent in 1974. Nonresidential construction increased only 3 percent in 1974 following an 8 percent increase in 1973.

Perhaps a more meaningful indicator is the construction industry's failure liabilities. According to the same report:

> Construction failure liabilities, after decreasing 13 percent in 1972, increased 58 percent in 1973 and 70 percent in 1974. Liabilities increased from $309.1 million in 1973 to $526.6 million in 1974.

The Subcommittee was told that because of this trend in the construction industry and other causative economic factors, the surety industry as a whole has suffered severe economic losses in the past few years. Statistics offered by the SBA, Surety Association of America, Imperial Agents, Ltd., and Richard Turner all indicate that during the past few years the surety industry as a whole has incurred losses and expenses in excess of 110 percent of the premium dollars received. Without a detailed audit of several sureties, it is impossible to determine the validity of this figure for those sureties who have specialized in SBG business.

As previously discussed, the SBA presently assumes 90 percent of the risk on a guaranteed contract in return for 10 percent of the premium dollar. This "risk-premium" ratio is administratively set by the SBA. The 90 percent risk is the maximum allowable statutory rate but the fees charged by the SBA are not specified in the law, although the agency is under a statutory duty to administer the program "on a prudent and economically justifiable basis." Because of the nature of the loss sustained by SBA, it has been suggested that SBA is not charging fees commensurate with the ultimate risk assumed.

There is no doubt that the SBG law has forced the agency to engage in a program which is predicated upon its assumption of an otherwise unmarketable risk. As stated by the Surety Association of America:

> It is essential to realize that the entire Small Business Bond Guarantee Program is based on the anomalous proposition of asking sureties voluntarily to approve bonds for small contractors as to whom a surety has already determined that they are unlikely to be able to do the particular job. Nevertheless, our surety companies have tried to educate their field forces to recognize those small contractors whose ability to compete is marginal (i.e., not probable but possible) and to select from these the contractors who can be made bondable by the addition of the SBA's financial guarantee and the utilization of SBA's other services.

The Surety Association of America stated further that it was "obvious that if you were going to write bonds for contractors that you were doubtful about, you were going to lose money."

One of the most expedient ways for SBA to reduce its losses in the program is to change the risk-premium ratio from 90–10 to a lesser percentage assumption of the risk and/or increased share of premiums. The effect of such a change on the incentive of sureties to participate in the program is somewhat nebulous. In order to properly comprehend this issue, a brief analysis of the sureties' participation in the SBG program is needed.

For purposes relevant here the surety industry can be divided into two subsections. The American Insurance Association described these classes as follows:

> The larger companies which have engaged in the surety business for an extended period of time and have a large volume of non-SBA business, and the smaller companies which have less than ten years of surety bond experience

and have the great bulk of their surety operations in the SBA program.

The latter type of sureties are typically called specialty companies and, according to Richard Turner, who represents several of these companies, specialty sureties depend upon high volume to achieve profit.

Of the 102 sureties which have participated in the program, 27 have accounted for 95 percent of all contracts awarded and 94 percent of their dollar totals. Not surprisingly, these 27 sureties also account for 95 percent of incurred losses sustained by SBA.

The larger, more established sureties have not fully participated in the SBG Program. According to the Surety Association of America, large sureties participate in the program only for social reasons and without the expectation of financial gain. The American Insurance Association explained the larger companies' rationale thus:

> Our companies participate without expectation of immediate profits. We graduate these contractors into the mainstream and if we can hold them as clients we then make a profit.

The Surety Association of America testified that since most companies are participating merely on a social basis, a shift in the risk-premium ratio would probably not be a decisive factor in their continued participation. However, it did state that as far as specialty companies are concerned, a change in the risk premium ratio would give them less incentive to participate but that a shift, for example to 80 percent–20 percent would not result in specialties withdrawing from the program.

The SBA believes it can double its surety guarantee fee from 10 percent to 20 percent of the surety's premium "with little adverse effect upon surety participation." As far as the percent of risk assumed, the SBA has not reached a final decision. Among the approaches discussed, however, include the SBA tying its percentage of guarantee to the surety into that surety's incurred loss rate in the SBG Program. "In other words, the higher their loss rate, the less will be our guarantee." [5]

In addition to the foregoing, the American Insurance Association indicated that it would be in favor of the SBA placing program restrictions on selected sureties:

> Those surety company participants that bring inordinate number of loss cases to the program should be restricted in future underwritings.

One other possibility which could be utilized to slow down the SBG Program, and thereby reduce dollar losses, would be for the Congress to raise the $2,000 amount pursuant to which a contractor must obtain a bond on Federal work under the provisions of the Miller Act. The extent to which this amount is raised will, in effect, be the amount of additional risk procuring agencies will assume on their construction

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[5] This approach is of doubtful administrative practicability since the SBA would have to take into account the loss rates of some 100 sureties in each of the 50 States where they may do business.

work. The Government itself, therefore, would replace the surety to this degree and would forsake its underwriting services (to be discussed infra) if this approach were adopted.

An SBA analysis conducted on the basis of a purportedly valid random sample indicates that approximately 86 percent of the SBG contracts are for Federal, State and local government jobs.[6] Approximately 31 percent of the government contracts considered in this analysis were awarded by the Federal Government, 12 percent by the States and 57 percent by local governments. The SBA study concludes:

> On the basis of this sample, we estimate that the total bid-spread differential for all government nonnegotiated SBG contracts awarded since the inception of the program in 1971 through June 30, 1975, was $61.7 million. This differential represents the amount of additional expenditures that the governments would have incurred had the SBG Program not been in operation. The bid differential for Federal Government contracts alone was estimated at $18.8 million. Without the surety bond guarantees the small business contractors would not have complied with Government bonding requirements, and these public contracts would have been awarded at a higher cost to the lowest non-SBG bidder who could have obtained the required bonding.

SBA contends that when its SBG losses are subtracted from the overall Government savings the program's justification becomes readily apparent.

Questions were also raised during the hearings concerning the adequacy of the guarantee given by SBA in the SBG Program.

According to testimony received by Mr. Turner, all private sector surety risks are reinsured by the surety. That is, a portion of each risk is shared by the surety with a separate and distinct insurance company called a reinsurer. The reinsurance treaty requires the reinsurer to "follow the fortunes" of the surety, that is, while the surety has sole administration of that bond, when the surety submits a claims voucher to the reinsurer setting forth the net dollar loss, the reinsurer automatically forwards its percentage of that loss in dollars to the surety. As a practical business matter, a reinsurer will pay a surety even in the face af a fraud perpetrated on the reinsurer by the surety, although the reinsurer thereafter would not again do business with that surety.

Turner believes that the SBA should, according to his interpretation of statutory intent, assume the traditional role of a reinsurer, although he concedes that SBA should not honor claims submitted when there is substantial evidence of fraud in the inducement by the surety itself. At present, the SBA has strained the statutory language, Turner argues, to a point where it denies liability:

> Through a Monday morning quarter-backing mechanism of second guessing the underwriting judgment of the surety or the settlement judgment of its Claims Department or the "rumor" within SBA that Producing Agent X was possibly negligent in analyzing Contractor Z's financial statement.

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[6] Study of the Small Business Administration Surety Bond Guarantee Program, August 23, 1975.

SBA's failure to assume a traditionally recognizable role in the surety industry has, we have been told, resulted in an uncertainty on the part of sureties which, to some extent, impedes their increased participation.

From an organizational standpoint, the SBG Program is highly centralized. The program is operated in nine of the ten regional cities and only one Region (IV) has been further decentralized to nine District offices on a test basis.

The Central SBG personnel are responsible for the execution of four major program areas:

(1) National Administration;

(2) Liaison with sureties, contractors, bond agents and brokers, various trade associations, as well as with other internal and external governmental bodies;

(3) Underwriting of all contracts/projects exceeding $500,000 in face value, and

(4) Processing of all claims against the SBG program's revolving fund; including desk audits of all claims files, pursuit of recoveries through sureties from contractors, as well as preparation for detailed audits of various files.

SBA employs the following personnel in Washington to perform these centralized operations:

A. Full time personnel: Five (one of whom is detailed elsewhere)

B. Part time personnel: Two (one for 16 hours per week; one for 20 hours per week)

C. Temporary personnel: Two (no permanent slots available)

D. Detailed: One (detailed to SBG for pursuit of recovery purposes)

In the field offices the SBG Program is delegated to personnel in 19 field offices, with less than 70 SBA personnel involved to any degree with SBG activities. However, on the basis of a field survey conducted in March 1975, SBA estimates that if it accumulated everyone's time spent on the program, the total would be 35 man-years, with a man-year being 2,080 man-hours.

While all private witnesses indicated that SBA was the proper Governmental agency to conduct this program because of its understanding of business and finance, there was general agreement that SBA operative personnel do not have the quality of expertise available in the industry, and that this was most apparent when the program first began in 1971. In fact, at least one such witness, Imperial Agents, stated that inadequate staffing of the Regional offices keeps the incurred loss ratio higher than it should be.

In response to questions submitted by the Chair, the SBA explained the extent of training afforded its personnel relative to this program:

Training

(1) Each of ten regional office staffs received intensive preliminary training during July and August of 1971. Guidance and counselling was continuously provided by letter and telephone instructions throughout the first two years of operations by Central Office staff.

(2) We conducted intensive SBG training for all SBG personnel in Washington, D.C. during the period June 26–28, 1974.

(3) Follow-up training was performed in each of our 10 regional cities during October and November 1974.

(4) More than 100 SBA employees (including all SBG personnel) participated in week-long SBG training sessions at either Raleigh, North Carolina (September 22–26, 1975) or Albuquerque, New Mexico (November 3–7, 1975), conducted at our request by industry professionals.

These training activities have cost the Agency an estimated $50,000 during the past 18 months; however, we believe this is money well spent, for, if better trained personnel have prevented only *two* contract defaults, we still will be ahead of the game since a contract default normally costs the Agency $27,000.

When Chairman Addabbo asked the SBA whether it needed more personnel to administer the program, the Agency responded, "Not necessarily," although it admitted all SBA programs generally indicate a distinct need for more personnel. The Subcommittee was assured, however, that this issue would be studied further.

Aside from the SBA personnel directly involved in the SBG Program, the Subcommittee is concerned that the Administration properly coordinate its other programs so that the SBG client is afforded the optimum potential for success. However, the Subcommittee was informed that SBG clients are not automatically given management and technical assistance even though relevant SBA forms do inquire of the client whether it thinks it needs this type of assistance. The Subcommittee was further informed of intensified present efforts geared to produce "an all-out effort within the SBA to achieve a 'full service' approach for SBA's contractor clients."

Historically, the SBA has approved 98 percent of the guarantee requests submitted by its more than 100 participating sureties. In absolute terms, SBA has approved, as of November 20, 1975, 52,477 applications out of a total 56,465 received. Of the approved guarantees, 31,621 resulted in award of low bid or negotiated contracts valued at a total in excess of $2 billion.

Given the relatively small number of SBA personnel assigned to the SBG Program, the Subcommittee inquired as to the time it takes such personnel to process this large volume of activity. As of July 1, 1975, the SBA believes it takes the typical SBA employee an average of three and one-half hours to process an application for a bond guarantee to a contractor who has had no previous SBG experience. At its next contact with the agency, if the contractor, for example, is the low bidder, SBA personnel spend an additional one and one-half hours to process the supplemental paperwork needed for the performance and/or payment bond. (It is interesting to note that in the Atlanta Region (IV), where the program is decentralized, it takes two and one-half times longer to process an SBG application than it does in the Dallas area, which is a centralized region.)

The SBA has recently engaged in efforts to reduce the paperwork and uncertainty of client contractors participating in the program.

The SBA has established bonding lines of credit between sureties and itself for particularly well qualified contractors. This program, now in the process of refinement, was initiated on March 24, 1975. It is estimated that in excess of 100 contractors are participating under this approach.

All of the problems associated with the operation of the program must be weighed against its potential and present benefits. As discussed previously, the SBG Program has resulted in costs savings to governments and governmental units which require bonding on its construction projects. However, the SBG Program is primarily intended to make bonds available to small contractors which are not bondable without the SBA guarantee. In addition, it is expected that contractors participating in the program will eventually "prove" themselves, join the mainstream of bondable contractors, and will no longer need this SBA assistance. The end product of this movement into the standard surety market is commonly called "graduation." While the SBA does not have statistics on the number of firms which have graduated from the program, the Administration doubts that there have been more than 1,000, although over 15,000 contractors have used the SBG Program over the past four years.

Of course, the concept of graduation is predicated upon the existence of a standard surety market which will undertake, without governmental guarantee, the risk that a contractor will adequately perform the conditions of its contract. Underwriting is the process whereby that risk is analyzed and is sometimes referred to as the prequalification function of suretyship. Theoretically, underwriting serves to "weed-out" those contractors whose potential for completing a particular job does not seem probable when the past performances, financial, and management resources of that contractor are scrutinized.

The decision as to whether an SBA guarantee is needed, therefore, takes place after the underwriter has determined the contractor's probability of success. Presumably, if the probability for success is very high, the surety will not seek the SBA guarantee which would necessitate its surrender of ten percent of the premiums plus added administrative expenses.[7]

Most of the witnesses, including the SBA, testified that during tight economic times, underwriting standards are raised, thereby effecting a prime cause for the problem of nongraduation. However, at least one reinsurance company, INA Reinsurance, takes exception to such statements, claiming that the present economic climate has made competition very keen and has resulted in "lower than usual construction bids and a *relaxing* of standards in underwriting." (emphasis supplied)

Another reason offered for nongraduation is the increased ceiling rate on contracts from $500,000 to $1 million. According to this theory, an increased ceiling acts as an incentive for contractors to compete for more and more jobs outside the range of their present work. Of course, the contractor's performance in these higher ranges is unproven and

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[7] The basis of this assumption is that the surety is legally able to take on new business, is willing to add to its list of regular clientele and there is no disincentive working against graduation such as higher agent and/or broken commissions paid by sureties for SBG contracts. As discussed *infra*, some agents and brokers also perform underwriting on the very bonds for which they receive commissions.

therefore the risk of failure greater. The SBA guarantee is sought by sureties in such situations to absorb part of this risk.

The Associated General Contractors of America took perhaps the strongest exception to the nongraduation problem:

> A.G.C. believes that the program presently supports and buttresses too many small business firms that either should be obtaining surety bonds through regular means or should not even be in business, and we have objected in the past to this manner in which this program has progressed.

A principal point of this objection is that participation in the SBG Program increases the competitive edge of those client-firms over the more established and larger contractors who do not qualify for this SBA assistance. A competitive edge, of course, is realized in those cases where an SBG client would pay, under SBA regulations, a lower premium rate than that charged to non-SBG clients. As stated by Richard Turner, in a fierce competitive market the difference in premiums charged on surety bonds can often account for the discrepancies in submitted bid prices.

It has been suggested that the larger, more established contractors object to the SBG Program because to them it only serves to increase their competition. The magnitude of such allegedly anticompetitive factors remains unknown.

The evidence did not indicate whether SBA has an organized effort to recruit the participation of more sureties in the program. However, in order to determine which sureties, upon their request, should be allowed to participate in the program, the SBA uses the Treasury Department's listing of approved sureties for Federal projects. Some sureties which are not on the Treasury Department's list are allowed to participate in the SBG Program, and in such cases the SBA claims it does "the same type analysis of the surety's financial condition, corporate structure, experience, etc., as the Treasury performs."

There is no doubt that the primary victims of a weak SBG Program are the small business firms intended by Congress to benefit from the program. However, because of unfortunate, but traditional, adverse economic patterns, minority-owned small business suffers the most from the nonrealization of the SBG Program's optimum operation.

The SBA estimates that, over the life of this program, approximately 25% of all guarantees have gone to nonwhite applicants. The evidence also indicates that in certain areas of the country, for example, Miami and Seattle, many minority contractors could not continue in business were it not for the SBG Program.

The very basic problem disclosed by the testimony is that, over the years, there has developed a business system which has traditionally excluded measurable minority participation. In the past more than the present, this system of conducting business transactions overtly precluded minority input. Currently, we more often encounter a business system which is racially neutral on its face, but because of past overt social and economic discrimination is presently operating, in effect, to perpetuate these past inequities. Minorities, until recently, have not participated to any measurable extent, in our total business system generally, or in the construction industry, in particular. However, inroads are now being made and minority contractors are attempting to "break-into" a mode of doing things, a system, with which they are empirically unfamiliar and which is historically unfamiliar with them. Friction is bound to arise and did, in fact, surface at the subject hearing.

Testimony received from the Central Contractors Association and Mr. Debro presented the Subcommittee with a series of allegations ranging from "red-lining" practices within the surety industry to particular sureties attempting to exert political and social controls over minority contractors. These allegations remain unproven, although they do present serious matters of concern to the Subcommittee for future investigations. The evidence, however, does indicate at the very least, grave lack of communication between SBA, participating sureties and minority contractors.

Of particular note to the peculiar problems faced by minority contractors is the fact that Federal procuring agencies and the SBA require Section 8(a) companies to obtain surety bonds for the work to be performed under the Section 8(a) subcontract.

Pursuant to Section 8(a) of the Small Business Act, the SBA is authorized to enter into contracts with Federal procuring agencies for the purchase of articles, equipment, supplies, or materials for the Federal Government. For the performance of such contracts, SBA is empowered to let subcontracts to business concerns by negotiation or otherwise. Administrative rules and regulations provide that this authority be utilized to aid businesses owned by the "economically or socially disadvantaged."

Under the 8(a) Program, SBA is the prime contractor. Technically, the Miller Act pertains only to those "persons" who receive prime contracts in excess of $2,000 from the Federal Government. Yet, under SBA's present interpretation of the Miller Act, the bonding requirements are passed down to the 8(a) subcontractor. While it is most apparent in this situation, it is equally true in all instances where Federal work is involved, that once the SBG is granted, one part of the Federal Government is, in effect, guaranteeing to another that it will pay 90 percent of the loss incurred by a surety if the contractor should not perform according to specification on the particular Federal job. While there may be some justification for this system on non-8(a) contracts because of the prequalification function of sureties, in the 8(a) program there is no such justification because the 8(a) contractor is, supposedly, thoroughly evaluated by SBA before it enters the program. That is, SBA has already prequalified the 8(a) subcontractor for a certain volume of work according to its approved business plan.

During fiscal year 1975, total 8(a) subcontractors were valued at $321.5 million and of this amount, over $60 million was for construction work.

Of continuing concern to the Subcommittee are the bonding problems faced by American Indian business persons. The Subcommittee has, during previous hearings, received evidence on this subject which indicates that many American Indian contractors have, for a variety of reasons, been precluded from both the standard surety bond market and full participation in the SBG Program.[8]

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[8] For further reference, see House Report No. 94-468, Minority Enterprise and Allied Problems of Small Business, September 10, 1975 and the Hearing Record of the same title, dated July 8, 9, 10, 1975, upon which that Report is based.

CHAPTER II. CONCLUSIONS

The Subcommittee concludes that the purpose of the Surety Bond Guarantee Program is to assist small business contractors to obtain bonds, otherwise unavailable, which are requisite to bidding and performing on certain contracts, and to eventually graduate such contractors into the standard surety market where they may secure bonds without SBA assistance. We conclude that the program is conceptually sound and is of extreme benefit to the small business community. However, we are constrained to find that unless certain measures are expeditiously undertaken, the potential benefit to be derived from the program will be greatly deteriorated in the short-term.

This program is predicated upon SBA's assumption of an otherwise unmarketable risk. While the statute does demand that the program be conducted "on a prudent and economically justifiable basis" we must concede the fact that the absorption of unmarketable risk will result in loss. The inquiry, therefore, should be whether the present and potential benefits derived from the program justify its costs. If such is the case, then the Subcommittee believes it would be "economically justifiable" within the meaning of the statute.

The SBA measures the success of the program by a comparative analysis of its losses and the savings to the Federal, State and local governments realized because many low bidders on such jobs were able to obtain surety bonds only through the SBG Program. While such results are desirable, the intent of the program is to help small business contractors obtain bonds and to become "bondable" in their own right—not to provide an alternate means of revenue sharing for state and local governments. The primary measure of success is, and should be, benefits derived by the small business community, that is, how many small businesses has the SBA assisted to become viable, ongoing concerns which now, because of the SBA's support, have access to the standard surety market. Testimony revealed that approximately 1,000 contractors have graduated from the program and that many minority contractors could not secure contracts were it not for the SBG Program. These facts present the Subcommittee with some immediate justification for the program, but more importantly, they indicate a potential for far greater benefit. However, while these gains are uppermost in our consideration, we do conclude that there is substantial room for improvement and that an optimum level of program implementation has not yet been realized.

We conclude that the chances for ultimate success or failure of this program presently rest with a very small number of specialty surety companies. It has been estimated that four such sureties write 60% of the SBG business. The fortunes of this program should not hinge on such a select number of sureties. Yet, we have found no organized effort on the part of SBA to attract the participation of more sureties. Furthermore, among the larger sureties we do find a distinct hesitancy to participate fully in the program. These larger organizations view the SBG Program as a form of social aid to minorities, rather than an economic incentive provided by the Congress to this industry in order to stimulate the growth of small business.

We cannot compute the economic benefit to the surety industry as a result of the SBG Program without a detailed audit of participating sureties, or a representative sample. Specialty sureties are not organized, so there is no central source of information upon which the Subcommittee may draw. However, the Subcommittee does not believe that a highly competitive segment of our economy would participate in this program, to the extent evidenced, without the immediate realization, or at least expectation, of profit.

The Subcommittee concludes that it is, in most instances, beneficial for Federal procuring agencies to obtain surety bonds from their contractors. Aside from the reduction of risk in the event of a default, the sureties do perform a valuable prequalification function which the Federal Government is not equipped to conduct on a mass scale. However, we believe that the $2,000 limitation imposed by the Miller Act of 1935 is totally unrealistic in today's economy and should be adjusted to take into account 40 years of monetary inflation.

The Section 8(a) Program presents a somewhat different issue. Before a firm can qualify for participation in the 8(a) program, it must submit a detailed business plan which is thoroughly analyzed by the SBA. The Administration, therefore, should be aware of the capabilities of such firm as well as its financial and management resources. In short, the SBA does "prequalify" the 8(a) company for a certain level of business activity. Since in the 8(a) program the SBA is the prime contractor, and has "prequalified" the 8(a) company, there seems to be no reason in law or logic why the requirements of the Miller Act should be imposed on the 8(a) subcontractor.

The Subcommittee finds that SBA operative personnel have, heretofore, placed insufficient emphasis on graduating contractors from the SBG Program. We fully realize that graduation depends on some economic factors outside the control of the SBA.

However, there are other factors within SBA's sphere of control or influence which could be utilized to expedite graduation. For instance, when an SBG application is submitted, SBA personnel do not conduct an independent investigation to determine whether or not the applicant contractor can obtain bonding in the standard market. It is presumed that the underwriter has already made a valid determination on that issue, even though the underwriter and the agent/broker may be the same person in a given case, and may decide to take this commission on the SBG business rather than expend his effort to "sell" the client contractor to the standard surety market. In addition, SBA could make a greater effort to provide SBG clients with more management and technical assistance, financial and procurement aid, etc., which will create a full service approach expediting the firm's growth and eventual graduation.

The Subcommittee, moreover, has been informed of certain allegations that there exist anticompetitive forces in the standard surety market which, to some measure, preclude SBG clients from graduating into that market. Without expressing any opinion as to the merits of these allegations, we are told that large, established construction contractors are opposed to the SBG Program because it brings them into competition with smaller firms who would not have this opportunity were it not for the SBG Program. Consequently, we are informed that these larger construction companies engage in certain activities designed to prevent their sureties from participating in the SBG Program or from servicing the needs of smaller contractors generally. To the Subcommittee's best knowledge, the SBA has not undertaken a study to determine if these allegations are valid, although if such conditions do exist, they would constitute a strong impediment to graduating firms from the SBG Program.

The Department of the Treasury maintains a list of sureties which are considered "financially troubled." The Department has refused SBA access to this list. Moreover, the SBA does not audit those sureties who participate in the program, although it does reserve the right to inspect surety files on SBG client contractors. The Subcommittee concludes, therefore, that the SBA does not have at its disposal adequate means to determine the financial soundness of participating sureties, even though it has incurred, through such sureties, contingent liabilities in substantial amounts.

When sureties submit claims to the SBA, the Administration conducts a "desk audit" to determine the validity of the claim. The SBA has not indicated to the Subcommittee any mechanism, such as spot audits, geared to protect against inflated claims.

The Subcommittee concludes that the SBA does require more personnel to properly administer this program. We approve of intensive personnel training on the surety industry and urge the Administration to expand its efforts in this regard. We also conclude that the SBG Program is highly centralized, but we attribute this fact to the lack of qualified personnel on the regional and district level and the peculiar problems associated with initiating a program of this magnitude.

The Subcommittee is of the opinion that at least some specialty sureties are uncertain as to the extent to which the SBA will honor its guarantee, i.e., what defenses the SBA may validly raise when it declines to honor a claim submitted by a participating surety. The Subcommittee believes that the SBA has not undertaken appropriate action, through the promulgation of rules and regulations or otherwise, to clearly define for the public its policy in this regard. Moreover, it seems contrary to business practice and basic logic for the SBA to deny a claim on the basis that the underwriter was negligent since the SBA implicitly approves of such judgments when it gives its guarantee.

The Subcommittee concludes that there is not enough empirical evidence to justify allegations that the larger the bond guarantee the greater is the risk of default. Further, statistics strongly indicate that most defaults and incurred losses occur on SBG contracts in the $0–$299,999 range, with the average size of a contract in claim status being $123,348. We therefore cannot conclude that raising the ceiling rate from $500,000 to $1 million was ill-advised, even though we believe contracts in that range should be closely scrutinized by the SBA since the potential monetary exposure on such contracts is extremely high.

The Subcommittee concludes that the financial status of the surety bond revolving fund is, at best, uncertain. This is, in no small measure, due to bureaucratic indecisiveness. Evidently, the SBA and Office of Management and Budget could not reach agreement as to whether the fund should be evaluated on a cash or obligational basis.

On a cash basis, we can readily conclude that of the $35 million appropriated to the fund, approximately $10 million remains available for obligation. Since authorized payouts for the last ten months (February through November 1975) average $1.3 million per month, the $10 million should carry the program through July 1976.

On an obligational basis, we must take into consideration not only the losses actually paid out but also those losses *expected* to be paid out sometime in the future. These expected losses are determined by the past experience of the Administration. On an obligational basis, the program would end fiscal year 1976 with an outstanding claim reserve for losses incurred (i.e., expected) but not yet paid, of approximately $18,750,000.

If the SBG Program for fiscal year 1977 is placed on an obligational basis to cover all accrued losses, the following appropriations would be needed:

1. Provide for the approximately $18.7 million of outstanding claim reserves accrued through the end of fiscal year 1976.
2. Provide for the interim period July 1, 1976 through September 30, 1977.
3. Provide for the program level approved for fiscal year 1977. This figure can be approximated by multiplying the program level for fiscal year 1977 by the incurred loss ratio of 2.42 percent.

The Budget submitted by the President to the Congress, for fiscal year 1977, indicates that OMB has now directed the SBA to operate the surety bond revolving fund on an obligational basis commencing October 1, 1976. The level of the program activity for fiscal year 1977 is $750 million. At this program level $18.1 million is required for fiscal year 1977 ($750 million × 2.42 percent), in addition to $18.7 million for outstanding claim reserves needed to place the fund on an obligational basis. The President has, therefore, asked Congress to appropriate $36 million to the revolving fund.

It is the conclusion of the Subcommittee that the fund should have been operating on an obligational basis since its inception. Heretofore, SBA's cash basis accounting was extremely myopic and has spiraled the program to a level of activity which was not adequately matched with a parallel increase in administrative resources or capabilities.

The Subcommittee concludes that it is appropriate and necessary for the SBA to devise means whereby it can increase its income by charging reasonable fees to client-contractors and sureties. However, these fees should not be such as to substantially decrease surety participation or place excessive financial burdens on the client-contractors.

The Subcommittee strongly believes that SBA should not use excessive fees in order to "slow down" the program. The program can be controlled by the SBA issuing to each of its Regions a quarterly allocation of budget authority for SBG operations. Excessive fees can drive some sureties from the program and do irreparable damage to client-contractors. Reasonable fees designed to alleviate part of SBA's expense to process applications, claim vouchers, and other administrative activities, are wholly necessary and appropriate.

The Subcommittee notes that SBA is presently contemplating amending its rules and regulations to effect, among other things, a shift in the "risk-premium" ratio to a 90 percent guarantee for a 20 percent share of the premiums (instead of the present 10 percent). Since the inception of the program, this ratio has always been 90–10 and, therefore, we lack empirical knowledge as to what effect this shift will have on surety participation in the program. SBA is, however, confident that a 100 percent increase in its share of the premiums will not drive the sureties from the program. Since the bulk of SBG activity is performed by specialty sureties the effect of this shift on them is critical. While the Subcommittee does approve of some limited and controlled experimentation in this regard, we strongly urge the SBA to closely monitor the effects of any potential shift in the risk-premium ratio and to immediately adjust such ratio whenever its effects can be considered deleterious to the purposes of the program.

The Subcommittee further concludes that while American Indian business persons have the most critical problems of any ethnic group in obtaining surety bonds, the SBA and other concerned Federal agencies have not undertaken substantive efforts to ameliorate this situation.

CHAPTER III. RECOMMENDATIONS

On the basis of all evidence received, further investigation by staff and Members of the Subcommittee, and the review of available data, the Subcommittee recommends:

1. That appropriate Committees of the Congress consider measures to:

(*a*) Increase the number of SBA employees assigned exclusively to the Surety Bond Guarantee Program;

(*b*) Raise the contract amount under the Miller Act whereby contractors on Federal projects must secure surety bonds. The level should be raised from the present limit of $2,000 to at least the equivalent amount in terms of 1976 dollars;

(*c*) Authorize and appropriate to the SBG Program sufficient funds to satisfy accrued losses and to meet the program level for fiscal year 1977, as requested by the President. However, the legislation should make clear that commencing with fiscal year 1977 the Program is to be conducted on an obligational basis.

2. That the Small Business Administration:

(*a*) Allocate to its Regions, on a quarterly basis, the funds appropriated by the Congress for the SBG Program;

(*b*) Report to this Committee, at least quarterly, the financial status of the revolving fund, and projected activity for the remaining quarters of the relevant fiscal year;

(*c*) Require each surety guarantee application to contain a statement by the surety as to its belief that the contractor is unbondable in the standard market, and the reasons underlying this judgment. If the application is granted, thereafter coordinate all of its other programs, both financial and technical, to address those problems which the surety deemed sufficient to preclude the contractors entrance into the standard surety market.

(*d*) Expel from the SBG Program those sureties which have been responsible for excessive losses, and place under restriction those sureties which otherwise indicate poor underwriting judgment.

(*e*) Conduct periodic field audits on selected claims submitted by participating sureties;

(*f*) Conduct periodic "spot" audits on selected sureties which, in the opinion of the Administrator, may be financially troubled;

(*g*) Extend every appropriate effort to increase the number of sureties which participate in the program;

(*h*) Promulgate rules and regulations clearly defining what defenses it may, in its opinion, validly raise as grounds for refusing to honor claims submitted by participating sureties;

(*i*) Decentralize the SBG Program wherever possible and desirable;

(*j*) Assign a person within the Office of Advocacy, Planning and Research to conduct a detailed investigation of the alleged anticompetitive forces within the surety industry, and the effect of such forces on the SBG Program and small business contractors generally.

(*k*) Eliminate bonding requirements for Section 8(a) subcontractors.

(*l*) Conduct surety bond business conferences, inviting sureties and local small business contractors to participate. Such conferences can be used to inform the small business community of the intricacies of the surety industry and the SBG Program.

(*m*) Conduct an investigation and study of the peculiar problems faced by American Indian business persons in obtaining surety bonds and report to this Subcommittee its findings by May 1, 1976. Said report shall contain appropriate legislative and/or administrative proposals as are deemed necessary to increase Indian participation in the SBG Program.

3. That the Secretary of the Treasury:

(*a*) Make every appropriate effort to assist the SBA to evaluate the financial soundness of participating sureties and those seeking to participate in the program;

(*b*) Make available to the SBA, on a strictly confidential basis, its list of "financially troubled" sureties.

Part II.—Purported First Amendment Restrictions on SBA's Loan Eligibility Criteria

Chapter I: Summary of Testimony

The Subcommittee has received complaints from small business concerns alleging that the Small Business Administration has unduly and improperly denied its financial assistance to certain categories of businesses because of purported First Amendment restrictions incorporated in its loan eligibility criteria. Pursuant to such criteria, SBA has denied financial aid to small concerns such as vocational high schools which offer ancillary courses in high school equivalency, manufacturers of records with recorded music only, and publishers of greeting cards.

The Subcommittee is concerned that SBA make every appropriate effort to strike an equitable balance between its statutory duty to assist small business and constitutional obligations under the First Amendment. It was with this purpose in mind that the Subcommittee invited and received testimony from the SBA and from persons representing the interests of two adversely affected small businesses.

Representative Edward I. Koch (D. N.Y.), offered testimony to the Subcommittee relative to International Career Institute, a small "for-profit" concern located in New York City. International Career Institute is a vocational school which offers secretarial studies and clerk-typist preparation. Ancillary to this primary business purpose, the school also offers courses in high school equivalency, remedial reading and English as a second language.

International Career Institute applied for an SBA guaranteed $35,000 bank loan. Under a letter dated April 21, 1975, the SBA New York District Office informed the school that:

> Our legal division has reviewed your request and found that because the school offers High School Equivalency preparation and English a [sic] second language, the School is not purely a technical School and is therefore, not eligible for financial assistance under the SBA Loan Programs.

Representative Koch informed the Subcommittee that he inquired of SBA why it had reached this decision and was told that the SBA:

> Has made it a policy not to grant loans to any school offering academic subjects of any type because "the government does not wish to be in a position, by financial assistance to such institutions, of influencing political or sociological ideas."

Mr. Koch took strong exception to SBA's action and stated:

> This policy which holds that such preparation may influence political and sociological ideas and should therefore not be subject to governmental influence, effectively discourages vocational schools such as the International Career Institute from providing curriculum which supplements students' training with knowledge to further their careers—and in my judgement is ridiculous on their part. These courses are not sophisticated courses and do not lend themselves to the discussion of political or sociological ideology but rather they are basic skills and language courses which serve only to prepare future graduates to cope in a highly competitive job market.

Mr. Koch urged the Subcommittee to consider the initiation of remedial measures which would insure "that schools like the International Career Institute are no longer discriminated against for arming their students with knowledge that will allow them to advance in their vocations."

The next witness to appear before the Subcommittee on this issue was Solomon Z. Ferziger, Esq., representing De-Lite Recorded Sound Corporation, a small business also located in New York City.

De-Lite is totally engaged in the production, sale and distribution of recorded music by various artists. In furtherance of this function, it does choose to record only those artists which it believes, in its business judgment, are most salable to the public.

In 1972, De-Lite had secured an SBA guaranteed bank loan for approximately $215,000. The loan has never been in default, the subcommittee was advised, and presently there remains an outstanding balance of about $90,000.

In 1975, De-Lite decided to embark on a "growth program" which necessitated additional debt financing. The principals of De-Lite, therefore, returned to their bank and applied to refinance their loan up to $350,000. The bank agreed, conditioned upon another SBA guarantee for the increased amount. Application was thereafter made to the SBA New York District Office which declined to grant its guarantee on the ground that De-Lite was engaged in "mass media communication." Ferziger testified, however, that De-Lite had not changed its basic business operations since the first loan was approved in 1972. Moreover, the Subcommittee was informed that former SBA Legal Opinion Digests indicate the eligibility of this type of business for loan assistance, but that more recent Digests have adopted a contrary position.

Mr. Ferziger suggested that in order to reach an equitable solution in this type of case, the SBA should establish certain criteria or conditions for a loan recipient, to be incorporated in the loan agreement. If these terms are breached, Ferziger suggested, the loan could be promptly liquidated by the SBA. This practice, we were advised, had been followed in the past by other SBA administrations.

The SBA, by its Acting Administrator Louis F. Laun, appeared before the Subcommittee and explained the Agency's position relative to this issue.

Pursuant to Section 4 of the Small Business Act, there was created a Loan Policy Board which was charged with the responsibility to:

> Establish general policies (particularly with reference to the public interest involved in the granting and denial of applications for financial assistance by the Administration and with reference to the coordination of the functions of the Administration with other activities and policies of the Government), which shall govern the granting and denial of applications for financial assistance by the Administration.

The Board originally consisted of the SBA Administrator, the Secretary of the Treasury and the Secretary of Commerce. Subsequently, the functions of the Board were transferred to the Administrator.

Pursuant to these powers, and the Administrator's authority to issue rules and regulations (15 U.S.C. Section 634(b)(6)), the SBA has promulgated the following, which appears at Title 13, Code of Federal Regulations, Section 120.2(d)(4):

> (d) Financial assistance will not be granted by SBA:
>
> (4) If the applicant is a newspaper, magazine, book publishing company, television broadcasting company, film production company, or similar enterprise.

The SBA added that:

> The language of the regulation is taken, without significant change, from the loan policy statement adopted by the first Loan Policy Board on September 16, 1953, which, in turn, was based upon an almost identical policy statement of the RFC.

The Subcommittee was further informed by the Acting Administrator that SBA does not believe the Administrative Procedure Act requires it to publish a notice of proposed rulemaking regarding its loan policies in the Federal Register. However, the Agency was quick to add that the:

> SBA has voluntarily published its loan policy rules in proposed form prior to adoption. The most recent revision of its loan policy regulation (Revision 6) was published as a proposed rule for public comment on March 9, 1973.

Aside from its legal foundation, the SBA contends that its policy in this regard "is supported on its merits by a compelling logic." The Acting Administrator explained the Agency's rationale thus:

> The exercise of First Amendment rights can be almost as effectively inhibited by the hope of Government assistance as by the fear of Government sanction. Where financial assistance has already been received from the Government, there may also exist the fear of sanctions. A publisher or other disseminator of ideas and values might fear that the exercise of his constitutional freedom might cause the SBA to call its loan. If SBA were to abandon its present policy of nonassistance to disseminators of ideas and values, it would have to develop a substitute policy. Either assistance would be available to all disseminators, without regard to the merits of their ideas; or SBA would have to develop standards to determine which ideas were "good" and deserving of financial assistance, and which were "bad" and hence, undeserving.

In response to inquiries by Chairman Addabbo, the Agency explained its policy with respect to specific types of small business firms.

Vocational schools offering ancillary courses in high school education are deemed ineligible for SBA financial assistance because the SBA has made a determination that "the propagation of ideas and values is an inherent part of academic instruction . . ." The Agency, however, does not object to providing financial assistance to "straight trade or vocational schools."

In a similar fashion, the SBA has adopted a negative position with respect to record manufacturers which select the songs and the performers. This ineligibility "arises from the fact that music is a medium of expression by which ideas and values can be communicated, as well as emotions."

Finally, in the matter of greeting card publishers, the SBA declines to provide loan assistance on the basis that "greeting cards express attitudes." The SBA refuses to assume the role of a censor and, therefore, we have been informed, refuses to "assist in the propagation of ideas and values by any medium whatsoever."

In concluding his statement, the Acting Administrator explained to the Subcommittee:

> The eligibility of an opinion molder does not depend upon whether or not he is engaged in the propagation of ideas and values of a political or sociological nature—but rather upon whether he is engaged in the propagation of ideas or values of any kind.

Evidently, it is the above quoted philosophy which serves as the basic foundation for all SBA decisions in this subject area.

CHAPTER II: CONCLUSIONS

The Subcommittee concludes that the Small Business Administration is under a statutory duty to assist small business, but that this duty must be in balance with supervening First Amendment prohibitions.

The Subcommittee does not believe that the SBA should engage in activities which would necessitate its assumption of a censorship role. By censorship we mean the ability of SBA to direct a business as to what it can do or cannot do, relative to First Amendment protected activity, coupled with the power to enforce its will through the use of sanctions. The subcommittee believes such censorship would exist if SBA were to place in its loan agreements a prohibition against the promulgation of certain ideas and values, a breach of which would allow the Agency to liquidate the loan.

The Subcommittee concludes that SBA's rules and regulations do not adequately state the Agency's policy on this issue. In fact, the regulations merely list examples of ineligible concerns, and broadens its impact by including the term "similar enterprise." The Subcommittee finds that such regulations do not provide the small business community with sufficient notice as to the actual operating restrictions in this area.

We further find that, as evidenced by the De-Lite case, SBA operative personnel have apparently misapplied the Agency's "policy" in at least one case. We believe further incidents of this nature are likely to recur unless clearly defined rules and regulations are promulgated.

CHAPTER III: RECOMMENDATIONS

On the basis of all evidence received, further investigation by staff, and the review of available data, the Subcommitttee recommends:

1. That the Small Business Administration:

   (*a*) Formulate and publish rules and regulations which clearly define its policy with respect to First Amendment considerations in its loan eligibility criteria.

   (*b*) Take every appropriate action to ensure that its operative personnel are uniformly applying the Administration's policy on this issue.

2. That the House Small Business Committee:

   Monitor the response to the recommendations made herein and take whatever further action is deemed appropriate.

Appendix A

Part B—Surety Bond Guarantees [69]

DEFINITIONS

Sec. 410. As used in this part—

(1) the term "bid bond" means a bond conditioned upon the bidder on a contract entering into the contract, if he receives the award thereof, and furnishing the prescribed payment bond and performance bond.

(2) the term "payment bond" means a bond conditioned upon the payment by the principal of money to persons under contract with him.

(3) the term "performance bond" means a bond conditioned upon the completion by the principal of a contract in accordance with its terms.

(4) the term "surety" means the person who, (A) under the terms of a bid bond, undertakes to pay a sum of money to the obligee in the event the principal breaches the conditions of the bond, (B) under the terms of a performance bond, undertakes to incur the cost of fulfilling the terms of a contract in the event the principal breaches the conditions of the contract, or (C) under the terms of a payment bond, undertakes to make payment to all persons supplying labor and material in the prosecution of the work provided for in the contract if the principal fails to make prompt payment.

(5) the term "obligee" means (A) in the case of a bid bond, the person requesting bids for the performance of a contract, or (B) in the case of a payment bond or performance bond, the person who has contracted with a principal for the completion of the contract and to whom the obligation of the surety runs in the event of a breach by the principal of the conditions of a payment bond or performance bond.

(6) the term "principal" means (A) in the case of a bid bond, a person bidding for the award of a contract, or (B) the person primarily liable to complete a contract for the obligee, or to make payments to other persons in respect of such contract, and for whose performance of his obligation the surety is bound under the terms of a payment or performance bond. A principal may be a prime contractor or a subcontractor.

(7) the term "prime contractor" means the person with whom the obligee has contracted to perform the contract.

(8) the term "subcontractor" means a person who has contracted with a prime contractor or with another subcontractor to perform a contract.

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[69] Part B added by sec. 911(a)(4) of Public Law 91-609.

AUTHORITY OF THE ADMINISTRATION

SEC. 411. (a) The Administration may, in consultation with the Secretary of Housing and Urban Development and upon such terms and conditions as it may prescribe, guarantee and enter into commitments to guarantee any surety against loss, as hereinafter provided, as the result of the breach of the terms of a bid bond, payment bond, or performance bond by a principal on any contract up to $1,000,000 in amount, subject to the following conditions:

(1) the person who would be the principal of the bond is a small business concern.

(2) the bond is required in order for such person to bid on a contract, or to serve as a prime contractor or subcontractor thereon.

(3) such person is not able to obtain such bond on reasonable terms and conditions without a guarantee under this section.

(4) the Administration determines that there is a reasonable expectation that such person will perform the covenants and conditions of the contract with respect to which the bond is required.

(5) the contract meets requirements established by the Administration for feasibility of successful completion and reasonableness of cost.

(6) the terms and conditions of any bond guaranteed under the authority of this part are reasonable in light of the risks involved and the extent of the surety's participation.

(b) Any contract of guarantee under this section shall obligate the Administration to pay to the surety a sum not to exceed 90 per centum of the loss incurred by the surety in fulfilling the terms of his contract as the result of the breach by the principal of the terms of a bid bond, performance bond, or payment bond.

(c) The Administration shall administer this program on a prudent and economically justifiable basis and shall fix a uniform annual fee which it deems reasonable and necessary for any guarantee issued under this section, to be payable at such time and under such conditions as may be determined by the Administration. Such fee shall be subject to periodic review in order that the lowest fee that experience under the program shows to be justified will be placed into effect. The Administration shall also fix such uniform fees for the processing of applications for guarantees under this section as it determines are reasonable and necessary to pay administrative expenses incurred in connection therewith. Any contract of guarantee under this section shall obligate the surety to pay the Administration such portions of the bond fee as the Administration determines to be reasonable in the light of the relative risks and costs involved. "Within 30 days after the date of enactment of this sentence and at monthly intervals thereafter, the Administration shall publish the cost of the program to the Administration for the month immediately preceding the date of publication. The Administration shall conduct a study of the program in order to determine what must be done to make the program economically sound. Within one year after the date of enactment of this sentence, the Administration shall transmit a report to Congress containing a detailed statement of the findings and conclusions of the study, together with its recommendations for such legislative and administrative actions as it deems appropriate." [70]

(d) The provisions of section 402 shall apply in the Administration of this section.

SEC. 412. There is hereby created within the Treasury a separate fund for guarantees which shall be available to the Administrator without fiscal year limitation as a revolving fund for the purposes of this part. There are authorized to be appropriated to the fund from time to time such amounts not to exceed $35,000,000 to provide capital for the fund. All amounts received by the Administrator, including any moneys, property, or assets derived by him from his operations in connection with this part, shall be deposited in the fund. All expenses and payments pursuant to operations of the Administrator under this part shall be paid from the fund. From time to time, and at least at the close of each fiscal year, the Administrator shall pay from the fund into Treasury as miscellaneous receipts interest at a rate determined by the Secretary of the Treasury on the cumulative amount of appropriations available as capital to the fund, less the average undisbursed cash balance in the fund during the year. The rate of such interest shall be determined by the Secretary of the Treasury, and shall not be less than a rate determined by taking into consideration the average market yield during the month preceding each fiscal year on outstanding marketable obligations of the United States with remaining periods to maturity comparable to the average maturity of guarantees from the fund. Moneys in the fund not needed for the payment of current operating expenses or for the payment of claims arising under this part may be invested in bonds or other obligations of, or bonds or other obligations guaranteed as to principal and interest by, the United States; except that moneys provided as capital for the fund shall not be so invested.[71]

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[70] The requirements for monthly cost data and a study and report on the economic soundness of this program in last sentence of Subsection 411(c) were added by sec. 11(b) of Public Law 93-386.

[71] New section 412 added sec. 6(a) of Public Law 93-386. For further background, see footnote 68.

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